FX Forecasts
Desjardins Economic Studies
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Should we be talking about a currency war, or just a normal and necessary adjustment to exchange rates?

HIGHLIGHTS

- The actions taken by central banks with the goal of reaching an inflation target must not be confused with competitive devaluation.
- Accommodative monetary policy should continue weighing negatively on the U.S. dollar. However, it is important to note that a resurgence of tensions remains likely in the short term, a situation that would greatly benefit the U.S. dollar.
- Canadian dollar should end the year close to US$1.02. Despite the latest rather disappointing statistics, the Canadian economy is still in far better shape than many other advanced economies. By the end of this year, the market is likely to begin anticipating some monetary tightening once more.
- In the short term, the Italian elections at the end of February constitute the main risk for financial stability and for the euro. Given the signs that the recession in the euro zone is not over yet, the recent appreciation by the euro seems rather exaggerated.
- The probability that the Bank of Japan will fall short of expectations seems high. In the short term, the Japanese exchange rate may fall back below ¥90/$US.

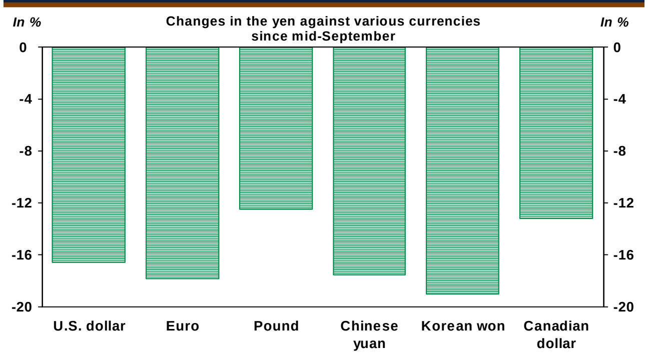
CONTENTS

Editorial

A country can reduce the value of its currency in an effort to stimulate growth by improving its trade balance. But other countries can suffer as a result; accordingly, there is a risk of deteriorating international relations and reprisals. This creates fertile ground for what is commonly referred to as a currency war, that is a spiral of competing devaluations. Is this what lies ahead?

Countries like the United States, Japan and the United Kingdom are currently coming under fire for maintaining an extremely accommodative monetary policy, in order to weaken their currencies. The recent depreciation of the yen is a very clear example of this (graph 1). In other places, governments or central banks are content with denouncing the strength or the overvaluation of their respective currencies. The European Central Bank (ECB) was quite subtle in this regard. In a press conference at the beginning of February, Mario Draghi mentioned that the appreciation of the euro could pose a downside risk for inflation, and that the ECB needed to take this into account in its analysis. It would seem, then, that many of the advanced

Graph 1 – Sharp depreciation of the yen since September 2012



Sources: Datastream and Desjardins, Economic Studies

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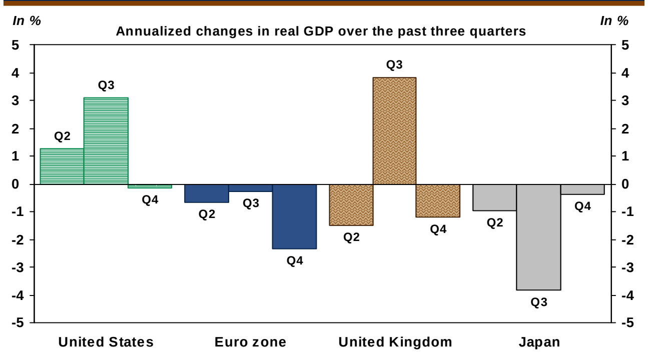
Note to readers: The letters **k**, **M** and **B** are used in texts and tables to refer to thousands, millions and billions respectively.

economies would like to take action to get their currencies to depreciate, but could it be that these exchange rate adjustments are normal and necessary to ensure the global economy's healthy growth?

THE MAJOR ADVANCED ECONOMIES NEED EASY MONETARY CONDITIONS

The United States, Japan, the euro zone and the United Kingdom have not yet recovered from the crises that assailed them, and are struggling to find a stable path to growth that would be strong enough to restore full employment. In fact, real GDP fell in the fourth quarter of 2012 in these four parts of the world (graph 2). The economic situation calls for very easy monetary conditions, especially since inflation targets might not be met otherwise.

Graph 2 – Economic downturn recorded in the Q4 of 2012



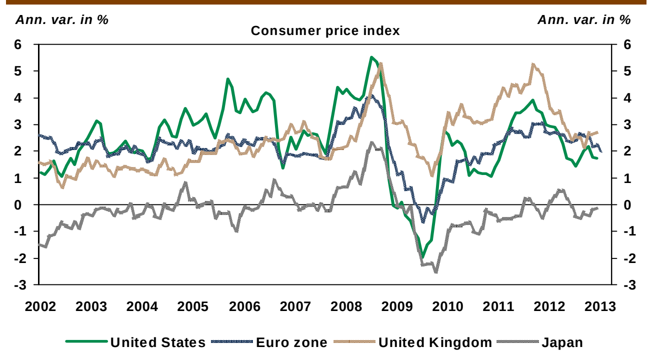
Sources: Datastream and Desjardins, Economic Studies

Currency depreciations cannot really be considered deliberate actions if they are the result of expansionist monetary policies adopted with the goal of reaching an inflation target. The 1970s and 1980s taught us how important inflation targets are for long-term economic growth and stable financial markets. It has been proven that such targets are more effective than others on the money supply, employment or the exchange rate.

Rather than a currency war, we should be talking about natural adjustments that are part of the normal channels through which monetary policy is transmitted. Apart from the effects on purchasing and investment decisions, monetary policy is transmitted by the revision of inflation expectations, the valuation of certain financial assets, and a depreciation of the exchange rate. Depreciation not only stimulates exports and business activity, but it also raises consumer prices for imported goods.

But there can be a thin line between natural depreciation and strategic depreciation, more typical of a currency war. By giving themselves too much flexibility in meeting inflation targets, the central banks could relax monetary conditions more than necessary and cause the currencies to depreciate too far. However, right now, the low inflation numbers are tending to prove most of the central banks in question right (graph 3). The situation may seem harder to justify in the United Kingdom, since the inflation rate there has been standing above the target for several years now. Nevertheless, the Bank of England stopped expanding its balance sheet last fall.

Graph 3 – Weak inflation does not suggest that monetary conditions are too accommodative

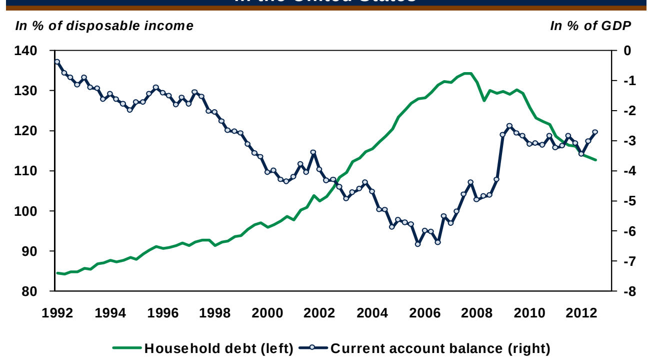


Sources: Datastream and Desjardins, Economic Studies

REBALANCING THEORY

Exchange rate trends can also be analyzed within a general framework of global economy rebalancing. The previous economic cycle was characterized by rising indebtedness and the accumulation of large commercial deficits in the United States and in other advanced countries (graph 4). Meanwhile, many emerging countries, including China, built up surpluses. To start off on a solid footing, these major macroeconomic imbalances must be corrected, and part of the solution lies in currency depreciation in the over-indebted countries and currency appreciation in the countries that have surpluses.

Graph 4 – Household debt and current account deficit in the United States



Sources: Datastream and Desjardins, Economic Studies

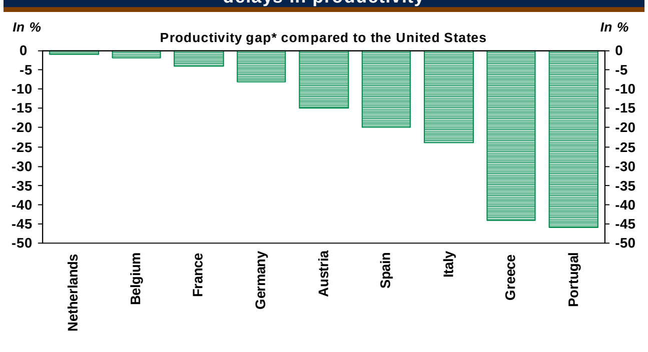
In many advanced countries, there is little point in looking to consumers or to the government to support the economy. Both of them need to repair their balance sheets. Business investment could make up for this, but the meagre growth expected in domestic demand for goods and services does not encourage businesses to expand their production capacity in any hurry. The gradual reduction of indebtedness in the regions at issue will eventually enable consumers and governments to make a greater contribution, but that will take time and, in the end, we will have to avoid falling back into the excesses seen in the past.

This is why a rebalancing of trade balances, and of exchange rates in turn, seems to be necessary. This means, though, that growth in the emerging countries will have to depend more on domestic demand. Interventions to limit the volatility of exchange rates could still be justified to ensure a smooth transition, but the long-term trend will have to be towards the revaluation of these countries' currencies, especially that of China.

WOULD STRUCTURAL REFORMS AND PRODUCTIVITY GAINS BE MORE EFFECTIVE?

Currency depreciation could be less natural and less necessary for certain advanced countries if more effort were made to increase productivity. Indeed, the ECB puts a good deal of stress on this aspect for the European countries that are struggling (graph 5). Productivity gains increase economic growth in the long term. The higher incomes thus generated in the economy not only stimulate consumption, they make it easier to save or pay back debts. Ultra-accommodative monetary policies would no longer be warranted to the same degree, and trade balances could be rebalanced more easily.

Graph 5 – Spain, Italy, Greece and Portugal have significant delays in productivity



* Productivity measured by GDP per worked hour.
Sources: Organisation for Economic Co-operation and Development and Desjardins, Economic Studies

If countries are reluctant to apply reforms to improve their productivity, they might be accused of preferring easy solutions, like depreciating their currency to stimulate growth. Constantly increasing productivity can be a major challenge, however. Competition, a skilled labour force, effective regulations and effective tax system are usually favourable factors in this regard.

A WAR-FREE FUTURE...

The global economy cannot afford to wage a currency war. It is important that the various countries establish, and follow, fair game rules. The actions taken by central banks with the goal of reaching an inflation target must not be confused with competitive devaluation, but sometimes the line between the two can be thin. It also seems normal for the currencies of countries facing debt problems to depreciate. On the other hand, adjusting exchange rates is not the only remedy.

Accommodative monetary policies are likely to continue weighing negatively on the yen and U.S. dollar in 2013 and 2014. The euro could also be negatively affected by further ECB interventions if inflation fell too far, or if financial tensions linked to sovereign debts built up again. It is important to note that a resurgence of tensions would also trigger another move towards safe-haven assets, a situation that would greatly benefit the U.S. dollar in the short term.

The rebalancing theory will mainly dictate exchange rate moves in the longer term. In this respect, the trend for the U.S. dollar is likely to be negative, especially against many of the emerging currencies.

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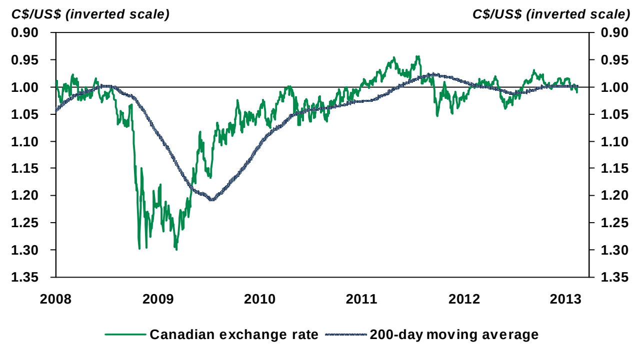
CANADIAN DOLLAR (CAD)

Disappointing economic data do damage

- The Canadian dollar does not seem to be benefiting much from the reduction in financial tensions and the decline in investors' risk aversion. After climbing close to US$1.02 in mid-January, the loonie softened against a backdrop of rather disappointing economic data in Canada. Recently, it fell back below parity with the greenback.
- From a market perspective, the correction to the loonie is still limited. The currency has not moved far from its 200-day average, and its momentum over three months is near neutral. However, investors have clearly revised their positions with regard to the Canadian dollar. Admittedly, the level of net speculative positions seemed exaggerated in January. A readjustment was necessary, and the risks of technical correction for the loonie seem much weaker now.
- Fundamentally speaking, the Canadian economy has recently shown a few signs of fatigue. The drop in housing starts in January confirms that the real estate is starting to slow down. Job growth was also disappointing in January, and the inflation rate fell to 0.8%, below the target range of the Bank of Canada (BoC). In such conditions, prospects of interest rate hikes seem far off in Canada. In fact, the BoC adopted a more dovish tone at its last monetary policy meeting, a turning point for the loonie. Investors now seem to be paying more attention to the Canadian data.
- There are still other factors that are in the loonie's favour. Canada enjoys an enviable financial position, and is well positioned, geographically, to benefit from the recovery of the U.S. economy. The high oil prices should also benefit the loonie, but its sensitivity to crude prices seems diminished, given the increasingly obvious difficulties in exporting oil from western Canada due to lack of sufficient infrastructures. Canadian oil has not risen in value as much as oil from other parts of the world; consequently, there has not been strong improvement in the terms of trade, and the currency is feeling the effects.

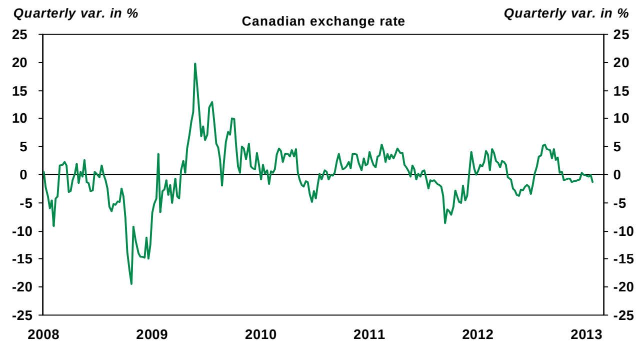
Forecasts: Any depreciation of the Canadian dollar below parity will probably be temporary, and it should end the year close to US$1.02. Despite the latest rather disappointing statistics, the Canadian economy is still in far better shape than many other advanced economies. Exports and business investment should support growth and offset the weakness of other components. By the end of this year, the market is likely to begin anticipating some monetary tightening once more, especially since inflation should rise. As for the price spreads between Canadian oil and that trading on international markets, they should diminish over time.

Canadian dollar and trend



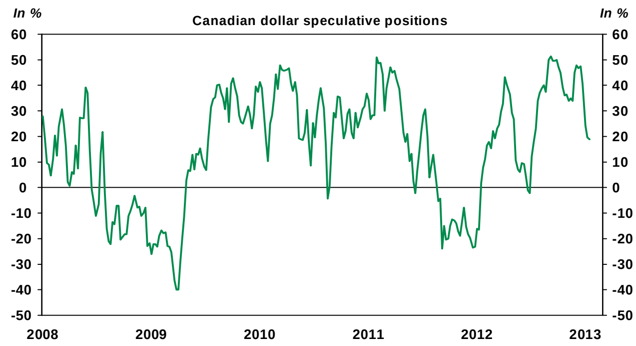
Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: momentum



Sources: Datastream and Desjardins, Economic Studies

Canadian dollar: net speculative positions



Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

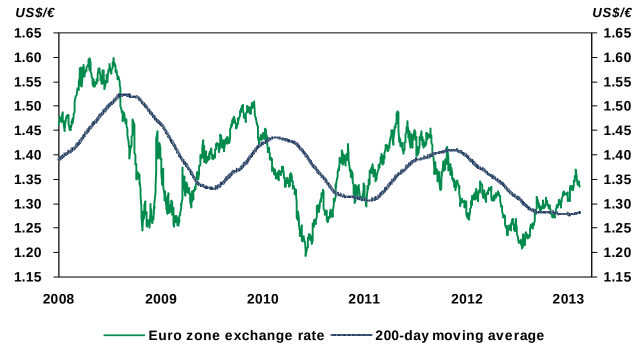
EURO (EUR)

Has the euro risen too fast?

- The euro has been on a tear throughout the month of January. It even rose above US$1.37 at the beginning of February, for the first time since November 2011. It has retreated somewhat since then, back below US$1.34. The concerns expressed by some European leaders that too strong a euro would exacerbate the zone's economic problems prompted some investors to take their profits on this currency.
- The sudden appreciation of the euro, combined with the slide of the yen, reopened the debate about a possible currency war. In stating, in early February, that the euro zone should have an exchange rate policy, French President François Hollande seemed intent on adding fuel to the flames. But this position won very little support in the euro zone, certainly not from Germany or from the European Central Bank (ECB).
- This does not mean that the monetary authorities are ignoring what happens to the euro. The ECB still had a relatively positive tone at its meeting of February 7, but it did say that too much appreciation of the euro could generate downside risks on price stability. Given that the recession is continuing and inflation has fallen back very close to the ECB's target, a further rise of the euro might convince the ECB to cut its key interest rate one last time. These comments by the ECB contributed strongly to the euro's recent pullback. However, the ECB's balance sheet should keep contracting in the months to come, as the banks pay back their loans to the ECB.
- Despite slight improvement in some economic statistics, the euro zone is still in trouble. On the bright side, the drop in financial tensions does constitute a very important source of support for the common currency. Other positive developments include recent agreements on a European budget and a debt exchange between the Irish government and Ireland's central bank. But a major political scandal in Spain, which weakened the Rajoy government, and Silvio Berlusconi's advance in Italian opinion polls are signs that the situation is still fragile. The absence of progress on the issue of a banking union is also a source of concern.

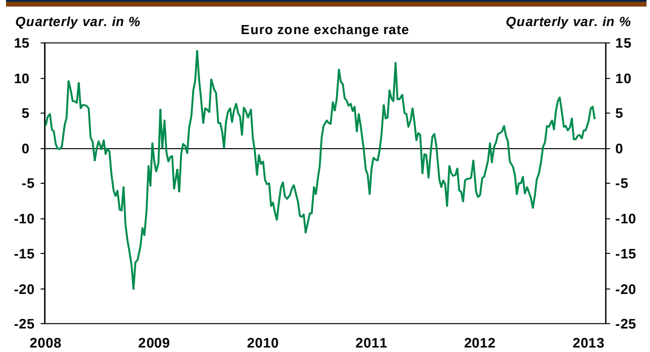
Forecasts: It is too early to declare that the European financial crisis is over, despite the positive developments of the past few months. In the short term, the Italian elections at the end of February constitute the main risk for financial stability and for the euro. Given that the recession in the euro zone is not over yet, the recent appreciation by the euro seems rather exaggerated.

Euro and trend



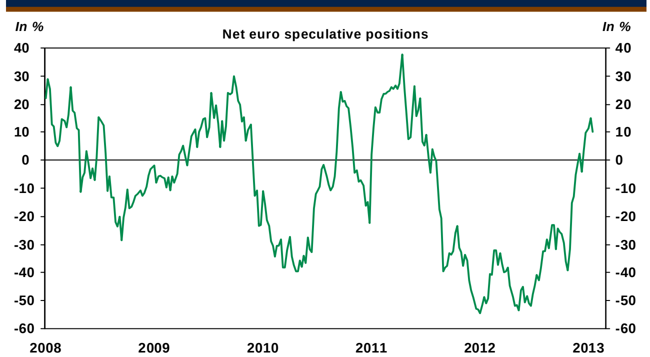
Sources: Datastream and Desjardins, Economic Studies

Euro: momentum



Sources: Datastream and Desjardins, Economic Studies

Euro: net speculative positions



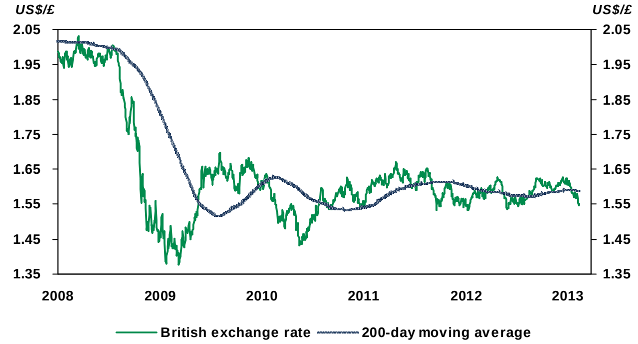
Sources: Chicago Mercantile Exchange and Desjardins, Economic Studies

BRITISH POUND (GBP)

The Bank of England wonders whether the pound is too strong

- The pound has pulled back by more than 4.0% against the U.S. dollar and by more than 5% against the euro since the beginning of this year. The pound's depreciation is mainly due to financial factors. The funds that had fled the euro zone are now exiting the United Kingdom to return to the continent. The British government is struggling to meet its deficit reduction targets, and fears that the United Kingdom might lose its AAA rating have risen sharply. Finally, the Bank of England (BoE) has suggested that the continuing large deficit in the current account could be a sign that the pound is too strong.
- Barring a surge in financial tensions, it would be surprising for the BoE to announce new quantitative measures, since it expects inflation to remain above its target until 2015. Moreover, the latest economic data seem to indicate that the British economy has started to pick up a bit after the downturn recorded at the end of 2012. In these conditions, **the pound's depreciation strikes us as exaggerated**, **and a rally is expected in the months ahead**, especially against the euro.

British pound and trend



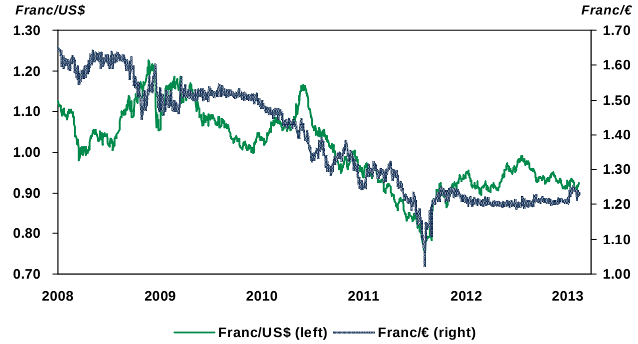
Sources: Datastream and Desjardins, Economic Studies

SWISS FRANC (CHF)

Keep an eye on the Swiss National Bank

- After appreciating against the U.S. dollar by nearly 3% in 2012, the Swiss franc has meandered around with no clear trend since the start of 2013. The sharp appreciation of the euro sent the EUR/CHF pair soaring to 1.257 francs in the middle of January, its highest point since May 2011.
- Recent events have enabled the EUR/CHF pair to move away from its floor level of 1.20 francs. The Swiss National Bank (SNB) established that floor level in September 2011 to combat deflation. In its press release last December, the SNB remained quite dovish, judging that there was no risk of inflation in the near future, and that risks of economic deterioration were still high. The SNB has nevertheless implemented measures to rein in the strong advance in mortgage markets and the residential real estate sector.
- **Any worsening of financial tensions in the euro zone should send the EUR/CHF pair back close to its floor level of 1.20 francs. But if these issues move to the sidelines in the second half of the year, the Swiss franc could depreciate quickly.** This could force the SNB to react to avoid overheating in certain sectors of the Swiss economy.

Swiss franc and trend



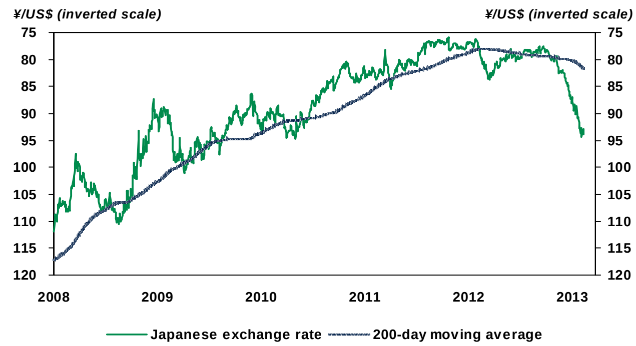
Sources: Datastream and Desjardins, Economic Studies

YEN (JPY)

Has the depreciation gone too far?

- The yen has lost more than 16% of its value against the greenback since fall. The return to power of the Liberal Democrats in Japan has considerably raised expectations about Japan's monetary policy. Even during the election campaign, they proposed that the Bank of Japan (BoJ) adjust its inflation target and expand its asset purchases. The BoJ fulfilled those expectations in part after its December and January meetings. The inflation target was raised to 2%, and new asset purchases were announced. Further actions are still expected and, once a new governor takes the helm of the BoJ in March, we may see a vigorous move in monetary policy.
- But there is a limit to what the BoJ can do. Its balance sheet is already quite large, and the depreciation of the yen means that the inflation target will be reached sooner. Thus, **the probability that the BoJ will fall short of expectations seems high. In the short term, the Japanese exchange rate may fall back below ¥90/$US.** In the longer term, the value of the yen is likely to keep following a downward trend against the U.S. dollar, based on the assumption that Japan will continue to face major structural problems.

Yen and trend



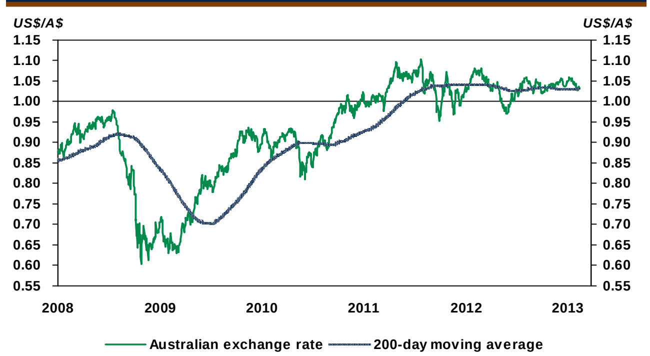
Sources: Datastream and Desjardins, Economic Studies

AUSTRALIAN DOLLAR (AUD)

The Reserve Bank of Australia maintains a dovish bias

- After closing in on the US$1.06 mark in January, the aussie has fallen to nearly US$1.02. From a market perspective, the enthusiasm at the start of the year may have seemed exaggerated, based on the high level of net speculative positions. From a more fundamental point of view, three factors are currently working against the Australian dollar. First, the stagnation or decline in many commodity prices is limiting possible improvements in the terms of trade. Second, the Australian economy is showing pockets of weakness apart from the natural resources sector, a situation that does not bode well if mining investments soon reach their peak and make a smaller contribution to growth. Third, the Reserve Bank of Australia (RBA) is keeping the door open to further interest rate cuts, precisely to ensure that other economic sectors will be able to step in and take over from the mining sector.
- The aussie should enjoy technical support at US$1.02. Even if the RBA announces further rate cuts, the returns in Australia will still be more attractive, relatively speaking. In the longer term, **improvement in the global economy should support commodity prices, and the Australian currency should win back a few cents**.

Australian dollar and trend



Sources: Datastream and Desjardins, Economic Studies

EMERGING CURRENCIES

Appreciation in sight

CHINESE YUAN (CNY)

- China's economic data have improved. The annual change in GDP rose to 7.9% in the last quarter of 2012. Retail sales have also accelerated lately, as have exports. But these results have not carried over to the yuan. The exchange rate has remained stable, at close to 6.23 yuan/$US, since November 2012.
- To prevent the currency from appreciating, Chinese authorities have resumed building up foreign exchange reserves. In addition, monetary policy is still accommodative. At only 2%, the inflation rate gives authorities the leeway needed to stay on course. However, **improvements in the economy will eventually translate into renewed inflationary pressures; at that point, it will be more difficult to keep the yuan's appreciation in check**.

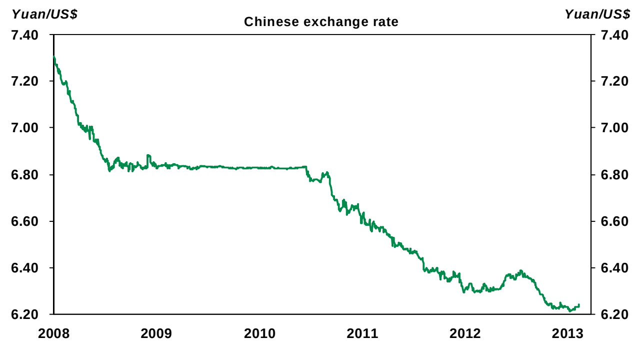
MEXICAN PESO (MXN)

- Relatively stable, the USD/MXN pair has fluctuated between 12.60 and 12.75 pesos since mid-January. The perception that the Bank of Mexico (BoM) might cut its key interest rate is the main factor curbing the peso's upward trend.
- A few months ago, the BoM threatened to raise its key interest rate. But the decline in the annual inflation rate, from 4.77% in September 2012 to 3.25% in January 2013, caused the BoM to change its position. It even adopted a dovish tone in January, asserting that it might be advisable to lower the key rate to allow the economy to adjust to lower growth and lower inflation. Despite a pullback in industrial production, the Mexican economy's performance is still acceptable, and it is unlikely that the BoM will take any action in the months ahead. **The peso should therefore stay close to its current level.**

BRAZILIAN REAL (BRL)

- For several months now, exchange rate fluctuations have mainly been contained within a range of 2.00 to 2.10 real/$US. But that trend was broken when the Central Bank of Brazil (BCB) appeared to close the door to further interest rate cuts at its last monetary policy meeting.
- Inflation, which rose again in January, now appears to be a greater source of concern than the exchange rate. Standing at 6.2%, the inflation rate is approaching the upper end of the BCB's 6.5% target range. Furthermore, economic growth accelerated in the second half of 2012, taking a weight off the monetary authorities' shoulders. The fact remains that the **exchange rate is a sensitive topic in Brazil, and it would be surprising if it were allowed to appreciate significantly without attempts being made to hold it in check**.

Chinese yuan and trend

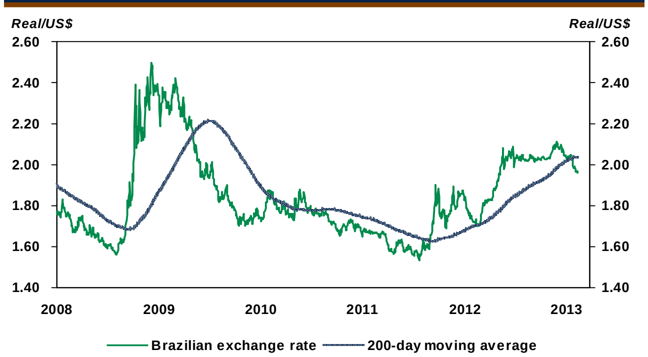


Sources: Datastream and Desjardins, Economic Studies

Mexican peso and trend

Sources: Datastream and Desjardins, Economic Studies

Brazilian real and trend



Sources: Datastream and Desjardins, Economic Studies

Table 1
Currency market

Country – Currency*	Spot price Feb. 18	Percentage return since 1 month	3 months	6 months	1 year	Last 52 weeks Higher	Average	Lower
Americas								
Argentina – peso	5.0113	1.2374	4.4282	8.6214	15.0425	5.0113	4.6337	4.3338
Brazil – real	1.9648	-3.8207	-5.4022	-2.7135	14.6964	2.1108	1.9866	1.7005
Canada – dollar	1.0099	1.6201	0.6478	2.1857	1.2939	1.0411	0.9980	0.9685
Canada – (CAD/USD)	0.9902	-1.5943	-0.6437	-2.1389	-1.2774	1.0325	1.0020	0.9605
Mexico – peso	12.6932	0.1871	-4.0680	-3.9402	-0.7254	14.4463	13.0937	12.5884
Asia and South Pacific								
Australia – (AUD/USD)	1.0297	-2.0079	-0.4685	-1.2151	-3.8768	1.0806	1.0342	0.9704
China – yuan renminbi	6.2427	0.4392	0.1139	-1.8181	-0.8914	6.3885	6.2978	6.2136
Hong Kong – dollar	7.7544	0.0232	0.0277	-0.0329	0.0084	7.7696	7.7562	7.7500
India – rupee	54.2650	0.9675	-1.6315	-2.6375	10.0152	57.1250	53.8558	48.9700
Japan – yen	93.9550	4.2959	15.5658	18.0858	18.1675	94.3250	81.6278	77.4900
New Zeland – (NZD/USD)	0.8455	1.0906	4.1089	4.7092	1.4880	0.8480	0.8132	0.7514
South Korea – won	1,082	2.3552	-0.9224	-4.5933	-3.8559	1,185	1,118	1,055
Europe								
Denmark – krona	5.5868	-0.2820	-4.5595	-7.4619	-1.1553	6.1688	5.7746	5.4693
Euro zone – (EUR/USD)	1.3351	0.4477	5.0804	8.5712	1.4282	1.3696	1.2904	1.2085
Norway – kroner	5.5552	-0.8292	-3.9773	-6.0828	-2.7170	6.1228	5.7722	5.4572
Russia – ruble	30.1209	-0.5336	-5.2101	-6.1251	0.6378	33.7117	30.9756	28.9975
Sweden – krona	6.3462	-2.5790	-6.5237	-4.8531	-5.5871	7.2694	6.7249	6.2899
Switzerland – swiss franc	0.9233	-1.2936	-2.6055	-5.4626	0.5938	0.9938	0.9366	0.8953
United Kingdom – (GBP/USD)	1.5480	-2.4176	-2.3098	-1.2567	-2.1183	1.6284	1.5882	1.5336

* In comparison with the U.S. dollar, unless otherwise indicated.
Note: Currency table base on previous day closure.

Table 2
Currency market: history and forecasts

End of period		2012 Q3	Q4	2013 Q1f	Q2f	Q3f	Q4f	2014 Q1f	Q2f	Q3f	Q4f
American dollar											
Canadian dollar	(USD/CAD)	0.9838	0.9922	1.0000	0.9901	0.9901	0.9804	0.9709	0.9709	0.9615	0.9524
Euro	(EUR/USD)	1.2865	1.3184	1.3200	1.3100	1.3200	1.3400	1.3400	1.3500	1.3500	1.3600
British pound	(GBP/USD)	1.6148	1.6255	1.5700	1.5800	1.6000	1.6200	1.6400	1.6500	1.6500	1.6600
Swiss franc	(USD/CHF)	0.9351	0.9153	0.9200	0.9200	0.9200	0.9300	0.9400	0.9400	0.9500	0.9600
Yen	(USD/JPY)	77.92	86.75	92.00	88.00	89.00	90.00	91.00	92.00	93.00	94.00
Australian dollar	(AUD/USD)	1.0376	1.0398	1.0300	1.0300	1.0400	1.0400	1.0500	1.0500	1.0600	1.0600
Chinese yuan	(USD/CNY)	6.2845	6.2303	6.2000	6.1500	6.1000	6.0500	6.0000	5.9500	5.9000	5.8500
Mexican peso	(USD/MXN)	12.86	12.87	12.70	12.80	12.60	12.40	12.20	12.00	11.75	11.50
Brazilian real	(USD/BRL)	2.0303	2.0432	1.9800	2.0000	1.9800	1.9500	1.9300	1.9200	1.9100	1.9000
Effective dollar*	(1973 = 100)	72.71	73.44	74.40	73.90	73.70	73.20	73.00	72.80	72.70	72.40
Canadian dollar											
American dollar	(CAD/USD)	1.0165	1.0079	1.0000	1.0100	1.0100	1.0200	1.0300	1.0300	1.0400	1.0500
Euro	(EUR/CAD)	1.2657	1.3081	1.3200	1.2970	1.3069	1.3137	1.3010	1.3107	1.2981	1.2952
British pound	(GBP/CAD)	1.5886	1.6128	1.5700	1.5644	1.5842	1.5882	1.5922	1.6019	1.5865	1.5810
Swiss franc	(CAD/CHF)	0.9505	0.9225	0.9200	0.9292	0.9292	0.9486	0.9682	0.9682	0.9880	1.0080
Yen	(CAD/JPY)	79.20	87.43	92.00	88.88	89.89	91.80	93.73	94.76	96.72	98.70
Australian dollar	(AUD/CAD)	1.0208	1.0317	1.0300	1.0198	1.0297	1.0196	1.0194	1.0194	1.0192	1.0095
Chinese yuan	(CAD/CNY)	6.3880	6.2793	6.2000	6.2115	6.1610	6.1710	6.1800	6.1285	6.1360	6.1425
Mexican peso	(CAD/MXN)	13.07	12.97	12.70	12.93	12.73	12.65	12.57	12.36	12.22	12.08
Brazilian real	(CAD/BRL)	2.0637	2.0593	1.9800	2.0200	1.9998	1.9890	1.9879	1.9776	1.9864	1.9950

f: forecasts; * Trade-weighted against major U.S. partners.
Sources: Datastream, Federal Reserve Board and Desjardins, Economic Studies